

## The Interaction between 403(b) Plans and Cafeteria Plans: A Primer

### What is a 403(b) plan?

An IRC § 403(b) plan (“403(b) plan”) is a retirement plan for certain employees of public schools and other tax-exempt organizations. A 403(b) plan allows employees to contribute some of their salary to the plan. The employer may also contribute to the plan for employees.

The following contributions to a 403(b) plan are permitted:

- **Elective deferrals** - employee contributions made under a salary reduction agreement. The agreement allows an employer to withhold money from an employee’s salary and deposit it into a 403(b) account.
- **Nonelective employer contributions** - contributions other than those made under a salary reduction agreement that include matching contributions, discretionary contributions and certain mandatory contributions made by the employer. The employee pays income tax on these contributions only when they are withdrawn.
- **After-tax contributions** - contributions (otherwise referred to as voluntary contributions that are not designated Roth contributions) made by an employee, which are reported as compensation in the year contributed and included in the employee’s gross income for income tax purposes.
- **Designated Roth contributions** - elective deferrals that the employee elects to include in gross income. The plan must keep separate accounting records for all contributions, gains and losses in the designated Roth account.

### What is a cafeteria plan?

In general, an IRC §125 cafeteria plan (“cafeteria plan”) is a written plan that permits employees to choose between a “permitted taxable benefit” (usually cash) and one or more “qualified benefits.” If the various IRC §125 requirements are satisfied, the availability of this choice will not result in taxable income to employees.

Basically, “qualified benefits” are certain benefits that employers can provide directly to employees on a tax-free basis, subject to specific exceptions. Some of the common benefits provided through cafeteria plans include group-term life insurance (I.R.C. §79), accident or health insurance (I.R.C. §106(a)), or adoption assistance (I.R.C. §137).

Cafeteria plans may allow participants to fund adoption assistance, dependent care and health benefits by diverting pretax salary reduction contributions into special reimbursement accounts, called FSAs. All FSAs are subject to special operational rules, including rules limiting the types of expenses they can cover.

Some of the key requirements for cafeteria plans are as follows:

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- A cafeteria plans must be established by, and maintained pursuant to, a written plan document that is adopted and effective on or before the first day of the cafeteria plan year to which it relates.
- The cafeteria plan year must be 12 consecutive months, except a short plan year is permitted for a valid business purpose. The plan year does not have to be a calendar year. Once established, the plan year cannot be changed except for a valid business purpose.
- Only employees can participate in a cafeteria plan, although their spouses and dependents can receive benefits employees obtain on their behalf through the cafeteria plan.
- The cafeteria plan must offer participants an opportunity to elect between at least one permitted taxable benefit and at least one qualified benefit.
- Permitted taxable benefits include cash compensation, payments for annual leave, sick leave, or other paid time off and severance pay.
- Elections must be made before the first day of the plan year to which the election relates, and typically may not be revoked or modified once the plan year begins. However, mid-year changes to elections are permitted in certain circumstances, as detailed in Treas. Reg. § 1.125-4.
- Only properly substantiated expenses for qualified benefits incurred on or after the date the employee is enrolled in the plan may be paid or reimbursed by a cafeteria plan.

As a general matter, cafeteria plans may not be used to defer compensation. However, there are two specific exceptions to this requirement: A cafeteria plan can be set up to permit employees to contribute to a health savings account (HSA) or make elective deferrals to a qualified cash or deferred arrangement as defined in IRC § 401(k)(2).

*Can employers and employees contribute to a 403(b) plan through a cafeteria plan?*

Employees may not be permitted to make elective deferrals to an IRC § 403(b) plan through a cafeteria plan. See Prop. Treas. Reg. § 1.125-1(q)(1)(x). However, employers can simultaneously maintain an IRC § 403(b) plan and a cafeteria plan. The following examples illustrate how a § 125 cafeteria plan and an IRC § 403(b) plan can coexist.

**Example 1**

*Employee can elect out of health insurance and have a set dollar amount be placed into a 403b account. The employee can receive the funds in cash.*

Employees may not be given the choice between health insurance, a 403(b) contribution, or cash. The reason is that this is a choice between 2 nontaxable benefits and 1 taxable benefit (i.e., cash), which creates a constructive receipt problem. In other words, everyone who has the option has to treat the taxable benefit they could have elected as taxable income, even if they didn't elect it. The only way to avoid the constructive receipt problem is to offer the election through a § 125 cafeteria plan; but as previously

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noted, employees may not be permitted to make elective deferrals to a 403(b) plan through a cafeteria plan.

**Alternative:** A similar result could be achieved through 2 separate elections. The first election, between health insurance benefits and additional taxable income, is made through a cafeteria plan. For those who choose cash, the second election is to defer some or all of this additional taxable income into their 403(b) plan accounts.

Note that this is not exactly like the facts in the original example because the employee has discretion to choose the actual amount that is diverted into the 403(b) plan, and how much is taken in taxable compensation. In other words, this second election is a mere employee salary reduction election.

### **Example 2**

*Same as 1, but the employee cannot receive the funds in cash.*

Effectively, the employer is offering employees a choice between health insurance and a contribution to a 403(b) plan. This is an invalid cafeteria plan election, and thus will result in adverse tax consequences for employees.

### **Example 3**

*Same as Example 1, but the employee can put the funds towards dental insurance, AFLAC insurance, Life Insurance, Medical Flex, Dependent Care flex or a 403b account. The employee cannot receive it as cash.*

As in Example 2, the employer effectively is offering employees a choice between a variety of benefits and a contribution to a 403(b) plan. This is an invalid cafeteria plan election, and thus will result in adverse tax consequences for employees.

### **Example 4**

*Same as Example 3, but the employee can receive the funds in cash.*

As in Example 1, this cannot be accomplished in a single election because contributions to a 403(b) plan cannot be made through a cafeteria plan. However, also as in Example 1, a similar result could be achieved through 2 separate elections: a cafeteria plan election between cash and one or more qualified benefits, followed by a salary reduction election to the 403(b) plan against the remaining taxable compensation. Note, however, that the cafeteria plan election must be between at least one taxable benefit and one or more “qualified benefits.” The AFLAC insurance and life insurance may not, in all cases, meet the definition of qualified benefits.

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